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SUBJECT: EDRC REVIEW JAPANESE ECONOMY, JUNE 28

REF: EDR (74)21

1. SUMMARY: SECRETARIAT DRAFT REVIEW (REFDOC) FOCUSES LARGELY ON PROBLEM INFLATION AND POLICY RESPONSE, NOTING TO LARGE EXTENT DEMAND MANAGEMENT COULD NOT HAVE EITHER PREVENTED OR LIMITED SIGNIFICANTLY EXCEPTIONAL INFLATIONARY DEVELOPMENTS. IT NOTES DEMAND MANAGEMENT HAS NOW SLOWED DOWN ECONOMY AND POLICY STANCE IS MAJOR ISSUE IN NEAR FUTURE. SECRETARIAT RECOMMENDS PROLONGED COOLING OFF PERIOD AND CONTINUATION SELECTIVE RESTRAINTS, RATHER THAN LARGE INCREASE IN DEMAND GAP. BALANCE PAYMENTS NOT SEEN RAISING INTRACTABLE PROBLEMS. END SUMMARY.

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2. SECRETARIAT DRAFT REVIEW (REFDOC) FOCUSES ALMOST

EXCLUSIVELY ON PROBLEM INFLATION AND POLICY RESPONSE OVER LAST 18 MONTHS. IT NOTES ACCELERATION PRICES SINCE 1972 HAS BEEN INFLUENCED BY NUMBER EXCEPTIONAL FEATURES, INCLUDING: (1) IMPORT PRICES - THE MOST IMPORTANT SINGLE FACTOR BEHIND ACCELERATION INFLATION IN 1973, ACCOUNTING ON AVERAGE FOR ABOUT ONE-HALF WHOLESAL PRICE INCREASE; (2) GENERALIZATION OF INFLATION WHICH GENERATED STRONG INFLATIONARY EXPECTATIONS; AND (3) BOTTLENECKS RELATED IN INITIAL PHASE UPSWING TO SHIFT IN COMPOSITION DOMESTIC DEMAND TOWARD HOUSING AND PUBLIC INVESTMENT AND LATER TO WORLDWIDE COMMODITY SHORTAGE AND TEMPORARY CUTBACK IN OIL SUPPLIES.

3. SECRETARIAT NOTES GAP BETWEEN DEMAND AND SUPPLY WHICH EXISTED END 1971 AND FIRST HALF 1972 WAS QUICKLY ABSORBED, AND BY MID 1973 PRODUCTION WAS AT POTENTIAL CEILING. ELEMENTS PLAYING IMPORTANT ROLE IN RAISING DEMAND PRESSURE ESPECIALLY IN 1973 WERE STOCK BUILDING, RISE IN BUSINESS FIXED INVESTMENT AND PRO-CYCLICAL BEHAVIOR HOUSEBUILDING. LARGE INCREASE IN PROFITS AND HIGH LEVEL LIQUIDITY PERMITTED CONTINUATION INVESTMENT BOOM EVEN AFTER RESTRICTIVE CREDIT POLICIES ADOPTED.

4. SECRETARIAT, IN ASSESSING THE MEDIUM TERM OUTLOOK FOR PRICE DEVELOPMENTS, NOTES TRADITIONAL DEMAND MANAGEMENT COULD ENSURE SLOWER RATE PRICE INCREASE BUT DOUBTS WHETHER REQUIRED DEGREE DEMAND RESTRAINT WOULD BE COMPATIBLE WITH RATE GROWTH OUTPUT AND PRODUCTIVITY FORECASTS (OF JAPANESE). SECRETARIAT SUGGESTS ADDITIONAL POLICY INSTRUMENTS MAY BE NEEDED CHANGE PAST RELATIONSHIPS TO OBTAIN SATISFACTORY GROWTH WITH REASONABLE DEGREE PRICE STABILITY. IT CALLS FOR CAREFUL EXAMINATION PRICE AND INCOMES POLICIES THAT MIGHT BE SUITABLE IN JAPANESE CONTEXT, INCLUDING WAGE INDEXATION TO PRICES.

5. SECRETARIAT CONCLUDES THAT RESTRICTIVE POLICIES HAVE NOW PRODUCED INTENDED MARKED SLOWDOWN LIMITED OFFICIAL USE

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IN DOMESTIC DEMAND AND OUTPUT REINFORCED BY DEPRESSIVE EFFECT REAL DEMAND SHARP INCREASE IN PRICES. IT EXPECTS THAT REAL CONSUMPTION, INVESTMENT AND GNP WILL SHOW ABSOLUTE DECLINE IN FIRST HALF 1974, WITH PROSPECT FOR MODERATE PROGRESSIVE UPTURN ACTIVITY OVER NEXT 12 MONTHS. UPTURN PREDICATED ON ASSUMPTION THERE WILL BE GRADUAL AND SELECTIVE RELAXATION MONETARY AND CREDIT SQUEEZE STARTING THIS SUMMER. IF

RELATIVE EASING DELAYED, ECONOMY WILL BECOME DISTINCTLY WEAKER AND REAL DOMESTIC DEMAND AND GNP MIGHT SHOW NEGATIVE RATES OF CHANGE FOR 1974 AS WHOLE. THIS WOULD BE UNDESIRABLE FROM BOTH DOMESTIC AND INTERNATIONAL POINTS VIEW.

6. AFTER DETAILED DISCUSSION DRAMATIC TURN AROUND IN JAPANESE BALANCE PAYMENTS BETWEEN 1972 AND 1973, SECRETARIAT CONCLUDES THAT WITH EASING DOMESTIC DEMAND

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PRESSURES IN 1974 AND HELP FROM DEPRECIATED YEN, EXPORT PERFORMANCE SHOULD IMPROVE CONSIDERABLY IN REMAINDER 1974 AND FIRST HALF 1975. IMPORT PRICES WILL CONTINUE TO SWELL IMPORT BILL BUT VOLUME GROWTH LIKELY BE SMALL. IMPACT RISE IN OIL PRICES WILL BE LARGE (\$11 BILLION IN 1974) AND CURRENT BALANCE WILL SHOW LARGE DEFICIT. HOWEVER, CA DEFICIT IMPACT ON RESERVES LIKELY BE CUSHIONED BY LOWER LONG-TERM CAPITAL EXPORTS AND FURTHER BANK BORROWING FROM

ABROAD. MAIN ADJUSTMENT TO BALANCE PAYMENTS DETERIORATION WILL HAVE TAKE PLACE IN CAPITAL ACCOUNT, AND SECRETARIAT NOTES JAPAN IS IN RELATIVELY STRONG POSITION ATTRACT ADDITIONAL FUNDS FROM ABROAD.

7. MISSION COMMENT: MEMBER JAPANESE MISSION OECD HAS COMMENTED ON PERSONAL BASIS THAT SECRETARIAT IS RATHER MORE OPTIMISTIC THAN JAPANESE ON FUTURE PRICE PERFORMANCE OF ECONOMY. INFLATION CONTINUES BE LIMITED OFFICIAL USE

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NO. 1 POLICY PROBLEM FOR JAPANESE. HE THEREFORE THOUGHT SECRETARIAT'S EMPHASIS ON DOING SOMETHING TO AVOID TREND TOWARD WEAKNESS IN ECONOMY WAS MISPLACED, AND DISAGREED WITH ITS RECOMMENDATION TO EASE MONETARY AND CREDIT RESTRAINTS THIS SUMMER. WE WOULD POINT OUT THAT SECRETARIAT IS BY NO MEANS OPTIMISTIC IN ABSOLUTE SENSE. SECRETARIAT STATES RISE IN CONSUMER PRICES LIKELY PERSIST FOR SOME TIME WITH IMPORTANT IMPLICATIONS FOR 1975 SPRING WAGE NEGOTIATIONS. BEHAVIOR IMPORT PRICES AND LABOR CRUCIAL IN PRICE PERFORMANCE OVER NEXT YEAR.

8. REFDOCS WERE AIRPOUCHED WASHINGTON AND INTERNATIONAL AIRMAILED EMBASSY TOKYO, JUNE 14. IN VIEW IMPORTANCE JAPANESE REVIEW, MISSION WOULD APPRECIATE COMMENTS FROM BOTH WASHINGTON AND TOKYO. BROWN

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